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The impact of the options backdating scandal on shareholders ☆

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ABSTRACT

The revelation that scores of firms engaged in the illegal manipulation of stock options' grant dates (i.e. "backdating") captured much public attention. The evidence indicates that the consequences stemming from management misconduct and misrepresentation are of first-order importance in this context as shareholders of firms accused of backdating experience large negative, statistically significant abnormal returns. Furthermore, shareholders' losses are directly related to firms' likely culpability and the magnitude of the resulting restatements, despite the limited cash flow implications. And, tellingly, the losses are attenuated when tainted management of less successful firms is more likely to be replaced and relatively many firms become takeover targets.
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1. Introduction

The practice of compensating executives using stock options has spread dramatically across Corporate America in the last two decades. Since 1993, federal tax laws confer corporate tax-deductibility status to option grants, provided that, among other requirements, the exercise price of the options is no less than the market price of the company's stock on the grant date (i.e. the grant is at- or below-the-money). Furthermore, until 2004, the rules governing the reporting of grants allowed firms to delay the recognition of any related expense until the underlying options were exercised. Thus, it is not

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surprising that, during the period 1996–2004, few option grants were reported as in-the-money (i.e. exercise price lower than grant date stock price), reflecting their compelling reporting and tax disadvantage.[1,2]

Together with the popularity of stock option compensation have come alleged abuses of this instrument. In his groundbreaking article, Lie (2005) first proposes the "backdating hypothesis" to explain the systematically favorable stock price patterns surrounding option grant dates documented in earlier studies (Yermack, 1997; Aboody and Kasznik, 2000; Chauvin and Shenoy, 2001). Option grant backdating involves issuing (in-the-money) stock options to an employee on one date, while providing documentation falsely asserting that (at-the-money) options were issued at an earlier date when the company's stock price was equal to the disclosed exercise price. On March 18, 2006, *The Wall Street Journal* (2006) ran the story that many consider to be the spark initiating the backdating scandal. As of December 2006, at least 140 companies were under public scrutiny due to allegations that they engaged in *illegal* backdating of option grants.[3]

Companies accused of backdating face several potential problems as a *direct* consequence of such allegations. Conducting internal investigations of past option granting practices and correcting companies' historical financial records and tax returns requires time and resources, which may delay the public release of required financial statements. This delay could cause firms to run afoul of exchange rules, subjecting them to potential or actual delisting of their stock from the exchange.

Following internal investigations, for reporting purposes, backdated stock options need to be reclassified as being in-the-money on the *true* grant date, or surrendered, or repriced. Reclassifying past grants may lower firms' earnings over the options' vesting periods. If options are surrendered or repriced (and employees are not compensated in exchange) at worst historical earnings will not change, but they may increase depending on the reporting standard. In cases where these adjustments are material, historical financial records need to be restated and reissued to the investment community.

The tax rules regulating the treatment of at- versus in-the-money options are different both at the employee and at the firm level. Thus, correcting backdated options requires that tax computations be redone and both the company and its employees become potentially subject to the IRS for back-taxes, penalties, and interest. Furthermore, correcting backdated options may require: cooperating with investigations by outside regulatory agencies; dealing with class-action lawsuits and/or derivative actions by shareholders; paying make-whole bonuses to employees who received backdated options; and potentially violating debt covenants, forcing renegotiation, and/or payment of the resulting penalties.[4]

Despite the fact that correcting for backdating may result in large, downward adjustments to companies' reported earnings, the effect on cash flows is not uniformly negative or material. First, option compensation is a non-cash expense and its value can always be estimated, as of the grant disclosure date and thereafter, provided grants' characteristics are truthfully disclosed. Thus, on average, correcting historical financial records should have no direct effect, *per se*, on shareholders' wealth. Second, the cash flow effects due to tax corrections at the firm level, so far, have more often than not been positive. When negative, they do not typically represent a significant portion of the affected companies' market capitalization. Third, as foreseeable, the cost of lawyers and accountants hired to conduct internal investigations, cooperate with government agencies, and deal with shareholder litigation has reportedly been in the order of several million dollars. Nonetheless, the available evidence suggests these out-of-pocket costs are relatively small. Furthermore, so far, companies have not borne significant penalties, and even benefited in some case as a result of employees disgorging the ill-gotten gains from and/or forfeiting the tainted options without make-whole bonuses. Because the direct cash flows due the backdating scandal are arguably relatively small, our null hypothesis (*Direct Cost Hypothesis*) posits that a firm's involvement in the scandal is of no economic relevance. Stock prices, thus, should not react significantly to the numerous backdating-related disclosures we analyze, except to reflect out-of-pocket costs.

In a world where investors have imperfect information about firms—and the people who run them, however, managerial misconduct with little direct impact on firms' fundamentals can have a large effect on claimholders' wealth. Management's involvement in backdating practices may prompt investors' reassessment of the agency costs stemming from the separation of ownership and control (Jensen and Meckling, 1976). Typically, stockholders' losses around earnings restatements are in part ascribed to uncertainty regarding managerial competence and integrity (e.g., Dechow et al., 1996; Anderson and Yohn, 2002; Palmrose et al., 2004). Moreover, recent studies formalize the argument that investors' perception of disclosure quality, broadly defined as *information risk*, affects firm value (Duffie and Lando, 2001; Easley and O'Hara, 2004; Yu, 2005; Kumar et al., 2006; Epstein and Schneider, 2008). Lower (perceived) quality disclosure should be

[1] Hall and Murphy (2003) show this trend was well underway in the previous decade and argue it is largely driven by the lower "perceived cost" of stock options relative to other forms of compensation.

[2] Hall and Murphy (2000) report that, in 1998, 94% of grants to CEOs of S&P 500 firms were reported as at-the-money on the grant date. Executives received at-the-money grants in at least 62% of unscheduled grant dates and none of the scheduled grants was reported as being in-the-money in the period 1996–2005 (Heron and Lie, 2007).

[3] Although backdating can be legal, if the practice receives board approval and it is properly disclosed for reporting and tax purposes, most companies involved in the backdating scandal allegedly violated at least one of these requirements. Chancellor Chandler wrote in a recent ruling: "All backdated stock options involve a fundamental, incontrovertible lie: Directors who approve an option dissemble as to the date on which the grant was actually made."

[4] As discussed later, involvement in the backdating scandal may *indirectly* affect accused firms, for instance, by forcing dismissal of valuable employees accused of being active participants in option backdating practices.

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